

January 29, 2002

Statement for the Record

Barbara J. Kosnar

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

On

Panel 1: Enforcing Compliance

Before the

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Secretary O'Neill, Commissioner Rossotti and Members of the IRS Oversight Board, my name is Barbara Kosnar, Senior Vice-President and Corporate Tax Manager for Union Bank of California in San Francisco, California and Chair of the American Bankers Association (ABA) Taxation Committee. I am pleased to be here before you today to present some of the ABA's thoughts on how the IRS can apply enforcement resources more effectively for businesses. I appreciate this opportunity to provide the concerns of the banking industry as they relate to IRS taxpayer services and how the IRS can improve its activities in the future.

The American Bankers Association (ABA) brings together all categories of banking institutions to best represent the interests of a rapidly changing industry. Its membership -- which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks -- makes ABA the largest trade association in the country.

We recognize that an enormous amount of time and commitment is required to implement the many IRS changes mandated by the IRS Restructuring and Reform Act of 1998. In recent years, our industry has appreciated the growing number of positive changes in attitude and approach from the IRS. The new and improved IRS as an organization is much better than the old one. However, much of the change has been at the senior management levels rather than throughout the IRS structure. We appreciate the changes that have occurred, and we recognize that a reorganization of a massive bureaucracy such as the IRS will take time, and it will take much longer for real change to occur at the examination level. For these reasons, we believe that the examination process for both the IRS and industry deserves an evaluation from a practical and cost effectiveness standpoint. Reasonable solutions could be implemented that provide the IRS with the ability to ensure compliance without wasting valuable taxpayer and IRS resources.

In my statement today, I would like to focus on the following areas:

- Communications with LMSB
- Industry Issue Resolution (IIR) program
- Communications between IRS national office and field agents
- Administrative burdens on IRS and taxpayer audit teams
- Information reporting

Communications with LMSB

I would like to first recognize the positive changes that have occurred as a result of the creation of the new Large and Mid-Size Business (LMSB) Division of the IRS. This division serves corporations, subchapter S corporations and partnerships with assets greater than \$5 million. Thus, the banking industry falls within the purview of LMSB.

The senior professionals in the financial services industry area of LMSB have applied innovative approaches to customer service that are greatly appreciated by the banking industry. Industry Director David Robison, Senior Industry Advisor Paul Claytor and many others within the financial services area have been very accessible and responsive to our numerous requests for information and assistance. While we may not always agree on issues, the customer service provided by the professionals in the financial services area are appreciated and should be encouraged to continue.

Industry Issue Resolution (IIR) Program - A Positive Step

During the past year, the ABA and a few other organizations and taxpayers participated in a new IRS program designed to address frequently disputed audit issues that are common to a significant number of taxpayers in a particular industry. The banking industry was an active participant in this Industry Issue Resolution (IIR) program, which began with a request for issues from the IRS LMSB Division (Notice 2000-65). After reviewing several submissions, the LMSB working team selected a longstanding bad debt conformity election issue, which we had recommended for resolution in the IIR program. Following this selection, the IRS industry representatives promptly began an aggressive and effective industry outreach effort. Both industry and IRS representatives strived to work together through various communications and face-to-face meetings in an attempt to resolve this sensitive audit issue that has not only created unnecessary confusion and uncertainty, but has produced many unpleasant examinations for banking institutions that have made the bad debt conformity election. An unusual collaborative effort was evident throughout the IIR process and IRS representatives routinely kept our ABA Taxation Committee and staff advised of developments and timetables. The IRS was sincerely interested in industry's views and achieving a resolution that would be acceptable to both industry and the IRS. The old adversarial approach between taxpayers and the IRS was not present during the IIR due diligence process.

Guidance on the IIR issue was timely produced (in Revenue Ruling 2001-59), including a recent Industry Directive Memorandum to examiners in the audit of the bad debt conformity election for banking institutions. Without direction to the field, the guidance produced would have no hope of being effectively implemented. The directive

acknowledged the joint effort of the IRS and the banking industry to clarify the bad debt conformity election.

While it remains to be seen whether the guidance produced through the IIR process does, in fact, eliminate uncertainty or encourages more banks to make the bad debt conformity election, the guidance does seek to reduce audit burdens on banks. We commend the IRS for creating the IIR program as a unique and effective approach for resolving issues. This IIR program should be expanded, as it promotes a more efficient use of IRS enforcement resources that benefits both the IRS and affected taxpayers.

The ABA recommends other issues for inclusion in future IIR programs. Two examples, both of which have been high priorities of ours for many years, include:

- *Book-tax conformity with respect to interest accrual on non-performing loans.* The current IRS rule requiring taxpayers to substantiate collectibility on a loan-by-loan basis is administratively impractical and creates substantial uncertainty.
- *Capitalization of expenses.* Recently, the Treasury Department and the IRS released an advance notice of proposed rulemaking (REG-125638-01) outlining specific categories of expenses that taxpayers would be required to capitalize. The rules include safe harbors and simplifying assumptions that are designed to significantly reduce uncertainty and controversy.

These issues, and possibly many others, directly impact a variety of businesses and could be effectively resolved in the IIR program.

Improve National Office and Field Agent Communications

Although the National Office may believe it has resolved a particular issue, that information is sometimes slow in reaching the IRS field agents. Some banking institutions have reported frustration with respect to agents who are unaware of current developments that may impact the audit. Many of these experiences appear to stem from a lack of coordination and communication between the IRS National Office and the field. In order to effectively apply IRS enforcement resources, communications in this area should be improved.

IRS pronouncements on court decisions is an area in which communication can be improved. From time to time, the IRS issues Actions on Decisions (AODs) indicating whether the IRS intends to contest or acquiesce with respect to a particular tax decision. tax directors have reported that such information rarely filters down to the field level in a timely fashion, thus causing administrative delays or other costly problems. In many instances, industry tax professionals provide this information to agents.

In an effort to more efficiently apply enforcement resources, the ABA recommends that the IRS continue to explore ways to improve communications from the National Office to the field. The IRS should educate agents, give them more responsibility and encourage settlements within reasonable guidelines. We also understand there are technology

challenges that the IRS may be grappling with, including the possible use of wireless technology and other means of providing information to the field at a high-speed.

Reduce Administrative Burdens on Audit Teams

The audit process is in need of improvement, especially as it related to administrative burdens on audit teams. For example, tax directors at many major banking institutions routinely report problems concerning unnecessary time consumption with the IDR system, third party contacts, and experiences with audit specialists. These concerns represent just a few of the complaints heard by tax professionals in the banking industry. However, some acknowledge that the IRS and taxpayers are working to improve the process.

Information and Document Requests (IDRs): IDRs, in many cases, represent a waste of otherwise productive resources. Many agents are aware of the unnecessary time consumption issues, but have little or no authority to remedy these problems. IDRs issued by the National Office often do not focus on a particular issue. The taxpayer is then burdened with trying to provide information without any apparent purpose other than to help the IRS develop an issue. As a result, much time is wasted with IDRs and the entire IDR process.

With respect to IDRs in general, many are too lengthy and unreasonably broad. Taxpayers are often unable to complete these open-ended IDRs in a timely fashion. These activities do not represent an effective use of enforcement or audit IRS resources. Encouraging limited scope audits, perhaps based upon a "materiality" concept and flexibility in the IDR process, would prevent a significant amount of unnecessary time consumption.

Third party contacts: Third party contacts is another area that is problematic. The IRS should not take lightly the notion of contacting third parties. Such activity by the IRS can result in significant friction between the third party and the taxpayer. Further, problems can occur if the IRS plans to either threaten a subpoena or make contact with a third party without working through the bank taxpayer. In addition to potential liability issues, such actions can cause significant delays in the audit process.

Audit Specialists: In recent years, the IRS has increased its use of audit specialists. Unlike revenue agents, these specialists are generally unfamiliar with a particular banking institution. An IDR issued from an audit specialist is generally lengthy, open-ended, overly complex and standardized. In some cases, this process may be repetitive of issues already covered with the field agent, or, worse, it may occur without the involvement of the field agent. This adds more time and resources to a process that, in many cases, is akin to a fishing expedition.

An example of repetition and delays is the process involved in extracting data from the taxpayer's computer mainframe. We understand that in some cases, an IRS computer audit specialist is required to approve IT security documents or certain extractions of

data. We believe this may represent an unnecessary layer of approval that could be streamlined to improve efficiency.

The examination process must be evaluated from a cost and resource management perspective. The IRS devotes too much time and energy seeking absolute certainty when a more realistic reasonableness standard should apply. The vast majority of banking institutions are very compliant. As a result, the IRS should consider reducing audit burdens on entities that are compliant and represent low audit risk. Some of the recommended solutions that the ABA supports include implementation of a materiality standard in selecting returns or documents, use of statistical sampling techniques and limited scope audits. Such changes would improve the audit process and allow the IRS and industry to more appropriately allocate resources.

Information Reporting

The banking industry files the bulk of information returns on behalf of the IRS. The entire tax information reporting process is a complex, time-consuming, and costly compliance requirement. As tax reporting becomes more burdensome, the IRS increasingly relies upon banking institutions to help verify taxpayer income and deductions. Positive changes cannot occur unless there is greater coordination and communication between the IRS and the banking industry. Since banks are affected by so many diverse tax reporting rules and are responsible for all bank-related reporting requirements, we believe that an ABA nominee be permitted to serve on the IRS Information Reporting Program Advisory Committee (IRPAC) on a continuing basis. Such a change will ensure that the IRS receives accurate industry input and data as it develops tax reporting rules and procedures that could significantly impact the banking industry.

Conclusion

On behalf of the ABA, I would like to thank you for the opportunity to present our views on issues that are important to the banking industry. We look forward to working with you and the IRS staff on these and other issues in the near future.